responsible-investor.com
ESG and sustainable finance

What can the sustainable investor do about fossil fuel divestment?

Tactical decisions can help an investor capture new opportunities related to climate change.

by Andre Bertolotti | March 12th, 2015

The question about fossil fuel divesting seems to be gaining more consideration with institutional investors. In its basic form, it is an ethical question: "Do we care about climate change?" However, divesting from fossil fuels has implications on the very mission of the funds that own them. Besides the ethical component, the divestment decision also has an investment case that can help asset owners gauge its merits. But once a divestment decision is made, the more difficult task becomes where to re-invest across the portfolio. Here is where the sustainable investor can bring insights and develop an edge.

The initial reactions from asset owners have been varied and often dependent on internal studies and evaluations. Some have concluded that there would be no benefit from fossil fuel divesting. Others have found that selective divesting was best. Still others have chosen to "decarbonize" their portfolio by using one of several low-carbon benchmarks that were recently launched. Some asset owners, instead, have publicly announced a complete divestiture from fossil fuels.

So how is the sustainable investors supposed to deal with fossil fuels? The best approach starts by changing the frame of reference, from one based on ethics (which is perfectly valid for some investors) to one based on risk and return (which is valid for all investors).

Fossil fuel divesting is not at the center of the debate which, instead, is about climate change, its causes and effects. If we could simply mitigate the impacts of global warming by divesting from fossil fuels, it would be an easy thing to do. In reality, asset owners are faced with the difficult task of linking climate change to their portfolio holdings with a financial justification.

For the institutional investor, I see two major themes developing to incorporate climate change risk into investment beliefs. One theme is long-term and strategic in nature, since it considers a shift of the world's economy away from fossil fuels. The other is near-term and tactical, taking advantage of stock mispricing as companies adapt to a low carbon economy. In both cases, investors are engaged actors aligning their beliefs with perceived market inefficiencies. The financial argument for the first theme is based on the rising costs of carbon emissions and devaluation of fossil fuel companies. With a time horizon out to 2050, progress in alternative energy, energy efficiency and emissions reduction will decrease demand for fossil fuels while increasing demand for climate-friendly technologies. As a result, the carbon risk not currently priced in the market will eventually move to full pricing. This scenario creates the "stranded asset factor" to which investors can gain exposure if they believe that climate change risk is not presently compensated in the market. A good solution is a low-carbon index that can provide an investor with both market exposure and a long-term bet against fossil fuels. This approach, outlined in a recent paper by Andersson, Bolton and Samama titlled "Hedging Climate Change Risk" consists of divesting from fossil fuels held in a market index while re-optimizing the remaining stocks to have a tight tracking error of about 50 basis points to the original index. The missing exposure from fossil fuel divesting can be reduced by rebalancing into non-energy stocks that are correlated with energy stocks, creating a "decarbonized" index position. Backtests and live performance of low-carbon indexes have shown performance histories close to the target market index, suggesting that a penalty from fossil fuel divesting can be mitigated.

Investors in low carbon indexes have further options while remaining active indexers. One option is to look at exclusion of assets on a case-by-case basis, as was recently proposed in an expert study for the Norwegian Government Pension Fund. Another option is to engage with portfolio companies along climate change issues.
An investor that has taken a low carbon index position, however, has only made an active decision on a small part of the index. For example, the Oil & Gas Extractive industry makes up about 5% of the S&P 500 index. The remaining bulk of the low carbon portfolio remains passive, removing the investor from opportunities that arise as companies adapt and compete in a changing economy.

Here is where the second theme becomes important as near-term, tactical decisions can help an investor capture new opportunities related to climate change. This option requires an investor to be an active manager with the ability to include climate change in the analysis of stock valuations. Borrowing the idea from Michael Porter's five competitive forces from 35 years ago, a company today faces a host of additional new forces that include supply chain risk, pressures from NGOs and active shareholders, new government regulations, water and resource scarcity, and reputational risk amongst others. Companies that position themselves to manage these risks while providing goods and services that meet changing demands will be more successful than their peers that lag behind and simply react to change. This is the premise of the second theme and ESG integration can provide key insights into stock mispricings. The link between ESG and company fundamentals is based on measures that proxy for management quality and strategic direction. From the risk side, ESG can proxy for how a company is responding to business risks while from the opportunity side, it proxies for how a company is positioning itself for new opportunities and changing competitive environment. To the extent that these qualities are not captured in the stock price, there are near term investment opportunities across all sectors in a portfolio and not just in the energy companies. For example, a value investor can analyze the consumer cyclical sector and look for companies that have strong fundamentals, good ESG characteristics and are trading at a discount. Within the climate change discussion, ESG integration is consistent with fossil fuel divesting because divesting is clear about what to exclude or sell but does not guide the buy decision. ESG, instead, can inform the buy decision since it offers insights into companies that have incorporated alternative energy sources, energy efficiency, and lower emissions into their operations and are leaders in their industry. So while divesting removes the “bad” companies from a portfolio, ESG can help find the “good” companies and keep the portfolio aligned with an investor’s climate change policies.

As planetary engineering helps us better understand human impacts on the globe, investors are well served to stay current on the debates. The Sustainable Investor is well positioned for taking a long-term view of these trends but can also gain with near-term strategies along the way.

Andre Bertolotti, CFA, is CIO and Managing Partner at Quotient Investors in New York City and a member of the New York Society of Security Analysts.